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Supreme Court of the United States

OCTOBER TERM, 1969

1135

VICTOR MUSCAT AND R. L. HUFFINES, JR.,

Petitioners,

—against—

NORTE & CO.,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Opinion Below

Petitioners have omitted citation of the opinion of the District Court rendered after trial, which is 304 F. Supp. 1096.

Preliminary Statement

Petitioners seek a writ of certiorari to review a judgment of the United States Court of Appeals for the Second Circuit, unanimously affirming a judgment of the United States District Court for the Southern District of New York after a trial on the merits.

Petitioners pose five questions which they contend require review by this Court (Pet. pp. 2-3). None of the questions raised presents a proper basis for certiorari because it is demonstrable that either (1) the questions presented are not involved in this case and are, therefore, entirely hypothetical, or (2) they involve contested issues of fact decided against petitioners by the District Court and affirmed by the Court of Appeals.

Additional Rules Involved

In addition to the statutes and regulations set forth in the petition (A 72-76), the following rules are involved: Rule 19 of the Rules of the Supreme Court of the United States; and Rules 8(f) and 15(b) of the Federal Rules of Civil Procedure.

Statement of the Case

The action is a derivative stockholder's suit brought on behalf of Defiance Industries, Inc. ("Defiance") against its principal officers, directors and controlling stockholders. The amended complaint asserts three causes of action. The first, a common law cause of action, based on diversity of citizenship, alleges that petitioners, together with one Edward Krock (named as a defendant, but not served), caused Defiance to issue a grossly excessive number of its shares in exchange for shares of Insurance and Industrial Enterprises, Inc. ("IIE"), a corporation 77% owned by petitioners and Krock (R 6a-12a).*

Liability on the second cause of action was conceded by petitioners and is, therefore, not involved on this application.**

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* References designated by the letter "R" refer to petitioners' appendix on their appeal to the Court of Appeals.

** The second cause of action, likewise a common law claim based on diversity of citizenship, alleges that petitioners and Krock appropriated an opportunity belonging to Defiance to acquire 10% of the stock of IIE at $20.94 per share at the very time petitioners and Krock were conspiring to sell these shares to Defiance at $70.51 per share (R 12a-13a). Judgment in the sum of $206,357 was rendered against petitioners on this cause of action. On their appeal to the Court of Appeals, petitioners conceded that they had appropriated this corporate opportunity and that they should have tendered the shares in question to Defiance at their cost.

The third cause of action alleges that petitioners secured stockholder approval of the exchange transaction between Defiance and IIE on the basis of a false and misleading proxy statement in violation of §§ 10 and 14 of the Securities Exchange Act of 1934 ("Act") and the SEC rules adopted thereunder (R 14a-18a).

The District Court awarded judgment with respect to the first cause of action upon the ground that petitioners had violated "their state-law fiduciary obligation to Defiance (first cause of action) by causing it to acquire all of the stock of IIE, 77% owned by them and their associates, at an inflated price" (A 35).* In this connection the District Court further held (A 32):

> "Plaintiff has established a clear case of gross and deliberate fraud on the part of defendants Huffines and Muscat, knowingly participated in by Krock, in breach of their fiduciary duties to Defiance's stockholders and with the purpose and effect of profiting at the expense of its stockholders. It is difficult to conceive of more flagrant and callous breaches of trust on the part of corporate fiduciaries than those found here."

The District Court also awarded judgment with respect to the third cause of action upon the ground that the proxy statement, on the basis of which the Defiance-IIE exchange was approved by the shareholders of Defiance, was false and misleading in material respects (A 19-29). The District Court expressly held (A 34-36) that petitioners had personal knowledge of the false representations made in the proxy statement (A 34-35).

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* Reference designated by the letter "A" refer to petitioners' appendix annexed to their petition.

Petitioners thereafter moved for a new trial on the ground of alleged newly discovered evidence. On that motion petitioners contended for the first time that the Court, in assessing damages, should have accepted the market price of the stock of Defiance as its fair value, rather than the fair value of $14.49 per share fixed by Hayden Stone & Co., petitioners' own expert (A 44).

In rejecting that contention, the District Court held (A 44):

> "Review of that record reveals that defendants' present contention to the effect that Defiance stock was over-valued is not only belated, but contrary to, and inconsistent with, the proof offered by the parties and the position taken by the defendants both at pretrial and trial."

The District Court, notwithstanding its view that petitioners' contention that the market price of Defiance's stock should be equated to its fair value was belatedly made, nevertheless, carefully explored petitioners' contention and concluded that (A 50) "while market price is properly considered as one of the factors in arriving at a value for Defiance stock, it is neither controlling nor conclusive".* After considering all of the elements usually taken into account in arriving at fair value, the District Court held that "The result of this process of valuation was the determination of fair value of Defiance stock of $14.49 per share * * *". (A 56)

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* The District Court noted (A 63) "The unreliability of such prices, in view of the extreme thinness of the market in Defiance stock and the fact that such lower prices may well have been attributable in part to defendants' own unconscionable conduct. . . ."

Petitioners, on their motion for a new trial, also contended for the first time that the award of damages should have been made to the innocent shareholders of Defiance, rather than to Defiance, itself (A 58). The District Court rejected that contention, holding (A 58) that "The general rule in a derivative action is that recovery is awarded to the corporation on behalf of which suit is brought * * *."

In unanimously affirming the District Court, the Court of Appeals held that "A study of the record shows ample support of Judge Mansfield's findings * * *". (A 3) The Court of Appeals concurred with the District Court that petitioners had "acted in violation of their fiduciary duties as controlling officers and directors of Defiance" (A 3) and that their conduct was the result of "calculated fraud" (A 5). The Court of Appeals also agreed that an award of damages to Defiance was the appropriate form of relief (A 4).

Petitioners thereafter moved for a rehearing limited to the question of prejudgment interest. The Court of Appeals remanded the matter to the District Court "for further consideration of prejudgment interest" (A 7) but "affirmed in all other respects" (A 8) the judgment of the District Court.

The Court of Appeals directed the District Court to give further consideration to whether the prejudgment interest awarded was "compensatory" and "in accord with 'fundamental fairness' ".* (A 7) In that connection, the Court of Appeals, among other things, directed the District Court to "make specific findings, first, on the personal wrongdoings of Huffines and Muscat". (A 7) Clearly, the Court's

* The issue of prejudgment interest was settled by stipulation, approved by the District Court (A 69-71).

direction did not, and was not intended to, as petitioners imply (Pet. fn. p. 12), negate its prior finding that petitioners were guilty of "calculated fraud". (A 5)

Summary of the Argument

None of the questions raised by petitioners present any basis for certiorari.

The first four questions posed by petitioners for review by this Court do not arise out of the facts of the case and are, therefore, entirely hypothetical. It is well settled that this Court will not render advisory opinions by reviewing issues which are not presented by the facts of the case before it.

The fifth question posed by petitioners involves an issue of fact decided against the petitioners by the District Court and unanimously affirmed by the Court of Appeals. It is equally well settled that this Court will not review concurrent findings of fact by two lower courts. Furthermore, since the judgment is also based on common law diversity grounds, any decision by this Court on federal grounds would not disturb the judgment.

1. *The First Question:* Petitioners contend (Pet. p. 18) that in awarding judgment in favor of Defiance, rather than to its innocent stockholders, the courts below were "strait-jacketed" by state law and further contend (Pet. pp. 21-22) that there is a conflict among the Circuit Courts of Appeal over whether, in a diversity case, federal courts are bound to apply state court remedies. These questions, advanced for the first time on this application for a writ of certiorari, do not arise from the actual facts of this case.

Neither the District Court nor the Court of Appeals in awarding judgment to Defiance, rather than to its share-

holders, was constrained to do so by any requirement of state law. Neither court made any reference to state law relating to the appropriate remedy, or to any possible conflict which might exist among the Circuit Courts of Appeal on this question. Both courts, *in the exercise of their discretion,* in awarding judgment in favor of Defiance, followed the traditional and generally accepted equitable principle that in a derivative suit the award of damages goes to the wronged corporation, not to its shareholders.* Accordingly, since the question of state law *versus* federal law, ie., the application of the doctrine of *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (1938), was neither raised nor involved in the case, the question of a conflict among the Courts of Appeal on the question was likewise never an issue in the case. It may not, therefore, be raised now. (*Stern & Gressman,* Sup. Ct. Practice, 4th ed. (1969) § 6.37 at p. 297)

The real complaint of petitioners is not based, as they contend (Pet. p. 20), on any alleged erroneous application of the *Erie* doctrine, or any conflict among the circuits, but rather, that the courts below refused to exercise discretion in petitioners' favor and awarded judgment in favor of Defiance, itself. This Court does not review the exercise of discretion by lower courts in the absence of a showing of a clear abuse. (*Moor* v. *Texas & New Orleans R. Co.,* 297 U.S. 101, 105, 80 L Ed 509, 511 (1935))

2. *The Second Question:* Petitioners contend (Pet. p. 12) that the courts below, in fixing the fair value of Defiance at $14.49 per share, ignored a stipulation in the pre-trial order that the shares had a market value of $11.625 per

* It would have been superfluous for the courts below to have distinguished between the applicability of state or federal law, since the judgment was based on a violation of *both* state and federal law.

share. The District Court, however, did not ignore the stipulation.

On the contrary, the District Court accepted the stipulated market price of Defiance's shares as the fact (A 53), but held that "it is neither controlling nor conclusive" (A 50) on the issue of the fair value of Defiance's shares. In view of the "thin" market prevailing, the Court accepted the report of Hayden Stone & Co., petitioners' own expert, that the fair value of Defiance's shares was $14.49 per share (A 44, 46-48, 54-55).

The stipulation in the pre-trial order as to "market value" was never intended to foreclose inquiry into the "fair value" of Defiance's shares. By the terms of the pre-trial order, that issue was reserved for the trial (R 147a, 148a). Indeed, throughout the trial, both sides accepted Hayden Stone's evaluation of Defiance at $14.49 per share, and the entire case was tried on that theory (A 44).

Accordingly, petitioners' contention that the courts below ignored the pre-trial stipulation does not accord with the undisputed facts.

3. *The Third and Fourth Questions:* Petitioners contend (Pet. pp. 12-14) (a) that this Court should review the question of whether *scienter* must be proved to recover damages for violations of §§ 10 and 14 of the Act and Rule 10b-5 and 14a-9; and (b) the extent to which reliance on the "clearance" by the SEC of a proxy statement negates fraud. Neither of these issues arises out of the facts of this case.

The District Court expressly found that petitioners had *knowingly* misrepresented material facts in the proxy statement and that they had "misled" the SEC by withholding this information from it (A 34-35, 37). The Court of Appeals

unanimously affirmed. Accordingly, the issues thus raised by petitioners are academic in this case and ought not be reviewed by this Court.

4. *The Fifth Question:* Petitioners contend (Pet. p. 3) that this Court should review the fairness of the Defiance-IIE exchange transaction. The fairness of the exchange was the principal issue upon the trial. On that issue of fact, the District Court held that the ratio of exchange was grossly unfair to Defiance, and the Court of Appeals unanimously affirmed. This Court will not review an issue of fact determined by the District Court and unanimously concurred in by the Court of Appeals. (*Berenyi* v. *Immigration Service,* 385 U.S. 630, 635, 17 L Ed 2d 656, 661 (1966).

Finally, it may be observed that review by this Court of the federal questions which petitioners purport to raise (Questions "2", "3" and "4") cannot affect the judgment in this case. This is so because the judgment here is based on common law diversity claims (as well as on federal claims). The judgment against petitioners for breach of their common law fiduciary duties would be unaffected, even assuming this Court believed that the courts below had erroneously construed, or applied, federal law.

POINT I

The petition should be denied because the questions posed by petitioners do not arise out of the facts in the case or they involve issues of fact.

This Court has consistently held that it will not grant certiorari to review hypothetical questions which are not presented by the facts of the particular case before it. As this Court stated in *Conway* v. *Adult Authority,* U.S. , 24 L Ed 245 (1970) at p. 298:

"* * * Thus, it now appears the State has documentary evidence that the actual facts simply do not present the issue for which certiorari was granted by us.

* * * * *

"In this state of affairs we decline to adjudicate this case. Were we to pass upon the purely artificial and hypothetical issue tendered by the petition for certiorari we would not only in effect be rendering an advisory opinion but also lending ourselves to an unjustifiable intrusion upon the time of this Court. Accordingly, the writ of certiorari is dismissed as improvidently granted."

Accord:

Stern & Gressman, Sup. Ct. Prac. (4th Ed. 1969), §6.37, p. 297;

Tyrrell v. *District of Columbia,* 243 U.S. 1, 61 L Ed 557, 558, 559 (1916);

S. S. Monrosa v. *Carbon Black Export,* 359 U.S. 180, 184, 3 L Ed 2d 723, 726, reh. den. 359 U.S. 993, 3 L Ed 2nd 986 (1959);

Dick v. *New York Life Ins. Co.,* 359 U.S. 437, 444-445, 3 L Ed 2d 935, 941 (1959);

McCarthy v. *Brunner,* 323 U.S. 673, 89 L Ed 547 (1944).

This well established rule applies to the first four questions presented by petitioners. We shall discuss each of the questions raised by petitioners in the order presented in the petition.

The First Question

Petitioners contend (Pet. p. 18) that in awarding judgment to Defiance, rather than to its innocent shareholders, the courts below were in a "strait jacket"; that "Federal remedies do not depend on State law even in diversity cases" (Pet. p. 19); and that in this case, "State law was erroneously applied"

(Pet. p. 20). Petitioners also suggest (Pet. pp. 21-22) that there is a conflict among the Courts of Appeal over whether the *Erie* doctrine is applicable and obligates federal courts in a diversity case to apply state court remedies. These contentions were not advanced in the courts below and are made for the first time on this application. This circumstance, alone, warrants denial of petitioners' application for a writ of certiorari. (*Moor* v. *Texas & New Orleans R. Co.*, 297 U.S. 101, 105, 80 L Ed 509, 511 (1935); *NLRB* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 503, 95 L Ed 479, 483 (1951)).

It is clear, moreover, from the opinions below that neither the District Court, nor the Court of Appeals, in awarding judgment to Defiance, rather than to its shareholders, was constrained to do so by "state law". Indeed, neither court made any mention of the requirements of state law, or of the question of a conflict among the circuits with respect to the applicability of state law. Petitioners did not raise, nor did the courts below discuss, the applicability of the *Erie* doctrine.

In awarding judgment in favor of Defiance, the courts below followed generally accepted equitable principles applicable to derivative actions in both federal and state courts and were in no way "strait-jacketed" by requirements of state law.* Accordingly, petitioners' reference (Pet. p. 20) to the court's alleged erroneous application of *Erie* v. *Tompkins, supra* has no relation to the facts of this case.

The District Court denied petitioners' motion for a new trial upon the ground that (A 58 to A 59):

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* Petitioners agree (Pet. fn. p. 22) that "neither the law of Ohio nor the law of New York would prohibit recovery directly to independent shareholders although the suit is brought derivatively on behalf of the corporation". Accordingly, since state law permits the remedy petitioners now urge, the courts below were not "straitjacketed" by state law.

> "The *general rule* in a derivative action is that recovery is awarded to the corporation on behalf of which suit is brought, and that the corporation may not be 'by-passed' by an award to individual stockholders on a pro rata basis, which would, in effect, declare a dividend of the corporate recovery. See *Liken* v. *Shaffer*, 64 F. Supp. 432 (N.D. Iowa 1946, per Graven, J.); *Keenan* v. *Eshleman*, 23 Del. 234, 2 A. 2d 904, 912-13 (1938); 13 Fletcher Cyclopedia of Corporations (1961) 641-47 § 6028.
>
> "This case does not fall within the exceptions to this rule which have occasionally been made to avoid unnecessary litigation * * * " (Emphasis ours).

In affirming, the Court of Appeals likewise based its decision on generally accepted principles of equity and made no distinction between state and federal court remedies in derivative suits. The Court of Appeals held (A 4):

> "The corporation by issuing shares to its controlling officers and directors for less than their fair value was obviously damaged to the extent of the difference which was $2,992,940 because it received IIE shares worth only $40.58 per share in return for its shares which were worth $70.51 per share. Under such circumstances those fiduciaries who caused the corporation to part with its assets for less than their fair value must make up the difference *to the corporation.*" (Emphasis ours)

Thus, the courts below, in the exercise of their discretion, adopted the remedy they deemed most appropriate in the circumstances, with regard to state law. It is clear that petitioners seek review by this Court, *of a principle* not presented by the facts.*

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* Even in those cases cited by petitioners (Pet. pp. 21-22), where the issue of state law *versus* federal law is alleged to have been involved, this Court never deemed the question of sufficient importance to grant certiorari. *A fortiori,* it should not be granted here, where the question does not arise.

Nor can there be any doubt that the form of relief awarded was altogether appropriate. It would seem to be elementary that when a corporation issues shares to its controlling officers and directors for less than their fair value, the corporation is damaged to the extent of the difference. (*Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 203 (5th Cir. 1960), cert. den. 365 U.S. 814, 5 L.Ed. 2d 693 (1960); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).) Obviously, if defendants had paid fair value to Defiance, it would have in its treasury the amount which they pocketed. Therefore, it is a *non sequitur* for petitioners to compare (Pet. p. 5) Defiance's damage with its prior net worth.

Petitioners advance the novel contention (Pet. p. 15) that Defiance's issue of an excessive number of its shares to acquire IIE resulted only in giving "a disproportionate equity in Defiance" to the IIE shareholders; and that "Defiance, itself, lost nothing" because it "gave up nothing but pieces of paper" (Pet. p. 10).

As the District Court found, and the Court of Appeals affirmed, the "pieces of paper", which petitioners exacted from Defiance, had a value of $14.49 per share (A 25, 2-3). It necessarily follows that Defiance was damaged when petitioners grossly underpaid it for the "pieces of paper" which they received from it.

As stated in *Hooper* v. *Mountain States Securities Corp.*, *supra*, (282 F. 2d at p. 203):

> "Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer so that the

> only persons who suffered were the stockholders for whom the suit cannot be brought by the Trustee."
>
> "* * * it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero."

Petitioners argue (Pet. p. 16) that "it is inequitable to take the rigid view that in every case where shares are issued by the corporation there is damage to the corporation if the shares issued are excessive in number". The fact is that the courts below did not take a "rigid view" of the relief to be awarded, but granted judgment in favor of Defiance after a careful review of all the circumstances. We do not perceive how it is "unrealistic and unfair" (Pet. p. 17) to petitioners to require them to pay Defiance the full fair value of the shares they exacted from it.

Upon defendants' theory, the recovery in a derivative action would rarely, if ever, go to the corporation. But it is the award of damages directly to shareholders, which is the rare exception.

In *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 432, 12 L Ed 2d 423, 427, this Court held:

> "The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done *to the corporation,* rather than from the damage inflicted directly upon the stockholder." (Emphasis ours)

In *Ross* v. *Bernhard, et al.,* U.S. ; L Ed 2d (Feb. 2, 1970), this Court again affirmed the principle that in a derivative suit

> "Although named a defendant, it [the corporation] is the real party in interest, the stockholders being at least the nominal plaintiff. The proceeds of the action belong to the corporation and it is bound by the result of the suit."

The consensus of the authorities is that:

> "Generally, where the action is a derivative one brought for the benefit of a going corporation, equitable principles demand that the theory of the action be recognized and that the whole recoverable amount be decreed to be paid to the corporation." (13 Fletcher, Cyclopedia of Corporations (1961, Rev. volume) § 6028, p. 641)

Accord:

> 2 Hornstein, *Corporation Law and Practice* (1959) § 731, pp. 246-247;
> Henn *on Corporations* (1961) Sec. 375, p. 592.

The District Court held (A 59), and the Court of Appeals affirmed (A 3-4), the instant case does not fall within the rare exceptions to the general rule that in a derivative suit the recovery belongs to the corporation on whose behalf the suit is brought. Accordingly, the District Court found that the cases cited to it by petitioners (Pet. pp. 17-19) were inapplicable (A 60); and concluded that (A 60):

> "Accordingly, since none of the special circumstances in which pro rata recovery has been awarded exist here, the theory of the derivative action must be recognized and recovery awarded to the corporation."

All of the cases cited by petitioners (Pet. pp. 17-20, 22-23) are either cases where the corporation on whose behalf

the suit was brought was bankrupt and the shareholders, therefore, had no standing to sue (*Marin* v. *England*, 385 U.S. 99, 17 L.ed 2d 197 (1966); or where a closely held corporation was involved and the action was essentially one among partners (*Gallagher* v. *Perot*, 112 Misc. 717, 183 N.Y. Supp. 257 (Sup Ct. 1918) aff'd 200 A.D. 867, 191 N.Y. Supp. 926, aff'd 234 N.Y. 516 (1922); or where the corporation was extinguished upon a merger* (*Southern Pacific R.R.* v. *Bogart*, 250 U.S. 478 (1919); *de Haas* v. *Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969)); or where the action was one for recovery by the suing stockholders individually or was an alternative to valuation proceedings, when no damage to the corporation was charged (*May* v. *Midwest Refining Co.*, 121 F. 2d 431 (1st Cir. 1941) cert. den. 314 U.S. 668, 86 L.ed. 534 (1941); *de Haas* v. *Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969); *Perlman* v. *Feldman*, 219 F. 2d 173 (2nd Cir. 1955), or where the suing stockholders were disqualified because they took their shares from the wrongdoers, or had acquired their stock after the date of the commission of the wrongs complained of (*Home Fire Ins. Co.* v. *Barber*, 67 Neb. 644, 93 N W, 1024 (1903); *Mathews* v. *Heedley Chocolate Co.*, 130 Md. 523, 100 Atl, 645 (1917)).

Petitioners' contention really is that in a derivative suit, involving the issue of corporate stock to fiduciaries for an inadequate consideration, the award *must* be made to the innocent shareholders (Pet. pp. 17, 22). If sustained, such a holding would seriously undermine the therapeutic utility

* Petitioners' intimation (Pet. fn. p. 19) that the merger of Defiance into El Tronics Inc. has some bearing on this case is incorrect. Defiance was merged into El Tronics long after the judgment was rendered here.

of derivative suits, particularly as a means of enforcing the provisions of the Act.*

This Court recently stated in *Mills* v. *Electric Auto-Lite Co.*, U.S. , 24 L.ed. 2d 593, 609 (January 20, 1970), that "private stockholders' actions of this sort 'involve corporate therapeutics' and furnish a benefit to all shareholders by providing an important means of enforcement of the proxy statute". Again, in *J. I. Case Co.* v. *Borak, supra* (377 U.S., p. 432) this Court held that "Private enforcement of the proxy rules provides a necessary supplement to Commission action."

Petitioners' reliance upon the decision of this Court in *Mills* v. *Electric Auto-Lite Company, supra,* is misplaced. In that case, Electric Auto-Lite was acquired on terms which were inadequate and unfair to its shareholders. The corporate existence of Electric Auto-Lite was extinguished upon the merger. As this Court pointed out in *Mills,* "Petitioners asserted the right to complain of this alleged violation both derivatively and *as representatives of the class of all minority shareholders*". (Emphasis ours) Plaintiffs in *Mills* sought to either void the merger, or to recover the fair value of their shares. Even under those circumstances, this Court did not determine the *form* of the relief, but left the selection of the proper remedy to "the sound

* To "by-pass" the corporation would inevitably lead to a hornet's nest of future litigation. The Court would be called on to determine whether stockholders at the date the vote approving the exchange was adopted, or at the date when the exchange was consummated, should share in the award. Also, the Court would be required to determine the amount of each shareholder's damage and whether the right to participate in the award passed with a sale of the shares. Undoubtedly, it would be also necessary for the Court to appoint a Master to adjudicate the claims and to supervise distribution.

discretion which guides the determination of courts of equity".

The instant case represents the reverse of the situation in *Mills*. Here, Defiance *paid* excessive consideration to acquire the outstanding stock of IIE, which was largely owned by petitioners and Krock. Defiance continued in existence thereafter. Obviously, Defiance itself could have maintained an action for damages against its faithless fiduciaries, and would have done so, were it not under their control. Had Defiance, itself, brought the action, any recovery it obtained would, necessarily, have belonged to it.

Apparently the real complaint of petitioners is that in "molding" the equitable remedy in this case, the courts below did not exercise their discretion as petitioners would have liked. But it is well established that this Court will not review the manner in which the courts below have exercised their discretion. (*Moor* v. *Texas & New Orleans R. Co.*, 297 U.S. 101, 105, 89 L ed 509, 511 (1935); *Appalachian Power Co.* v. *American Institute of Certified Public Accountants*, 361 U.S. 30, 4 L ed 2d 30, 80 S. Ct. 16 (1959); *N.L.R.B.* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 502-503, 95 L ed 479, 482-483 (1950).)

In any event, petitioners' contention that equity should "mold its decree" (Pet. p. 17) is beside the point. In a derivative suit, the stockholder plaintiff ordinarily stands in the shoes of the corporation and can enforce against its fiduciaries only those claims which the corporation itself could have asserted. As this Court declared in *Ross* v. *Bernhard*, *supra*, in sustaining the right of a derivative plaintiff to a jury trial:

> "The heart of the action is the corporate claim. If it presents a legal issue, one entitling the corporation to a jury trial under the Seventh Amendment, the right to a jury is not forfeited merely because the stockholder's right to sue must first be adjudicated as an equitable issue triable to the court."

In the case at bar, the cause of action against petitioners is essentially an action at law to recover money damages. This, in fact, was the only relief awarded by the District Court. There should be no doubt that, in the instant case, plaintiff is entitled to enforce the legal claim of Defiance to recover money damages, precisely as Defiance could have done, had it been in a position to sue in its own name.*

The Second Question

Petitioners contend (Pet. p. 12) that "both the District Court and the Court of Appeals completely ignored a stipulation incorporated into the pre-trial order that the shares of Defiance had a market value of $11.625 per share on the date the proxy statement was issued". Petitioners suggest (Pet. p. 26) that this alleged violation of F.R.C.P. 16 "should be remedied by this Court in its supervisory capacity".

The fact is that the courts below did *not* ignore the pre-trial order. The pre-trial order merely stipulated the market quotations of Defiance's shares based on "the average between the bid and asked prices" on May 8, 1962 (R 139a).

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* The doctrine that a derivative suit, though equitable in form, is in fact legal, if the corporate claims which the suit seeks to enforce are legal in nature, is well established. (*Potter* v. *Walker*, 276 N.Y. 15 (1937); *Dunlop's Sons, Inc.* v. *Spurr*, 285 N.Y. 333 (1941)).

There was no actual sale of any shares of Defiance on that date (R 122a).

The District Court *accepted* the stipulated market price of Defiance's shares "as one of the factors in arriving at a value for Defiance stock", but held that "it is neither controlling nor conclusive" (A 50). As petitioners would have it, the effect of the stipulation in the pre-trial order was to *preclude* the District Court from entertaining any *other* evidence of the fair value of the stock of Defiance. We submit that the pre-trial order does not provide, and was never intended to accomplish, any such result.

The purpose of a pre-trial order is to limit the issues and to avoid proof as to facts which can readily be proved. The market price of Defiance's shares was a fact that could readily have been established and was, therefore, stipulated. The materiality and relevance of this fact was expressly reserved for the trial (R 132a). It is absurd for petitioners to attempt to stretch this stipulated fact relating to *market price* into a concession, binding on the Court, that $11.625 was the *fair value* of Defiance's shares and that no other evidence on this issue was admissible.

Indeed, it is clear from the stipulation itself that the issue of the fair value of the Defiance stock was reserved for the trial. Thus, the stipulation provided that among "the issues to be tried" was whether the shares issued by Defiance on the exchange constituted "excessive and exorbitant consideration for the 99,998 shares of the stock of IIE acquired in exchange". (R 148a) Moreover, the pre-trial order expressly noted that "plaintiff claims that such excess is approximately in the sum of $3,335,000" (R 147a), a figure which could not have been remotely achieved if the market price of $11.625 were to be deemed final and controlling.

Moreover, throughout the trial petitioners and respondent both accepted the finding of Hayden Stone & Co., petitioners' own expert, that the fair value of Defiance's shares at the time of the exchange was $14.49 per share. This valuation was not put in issue by petitioners.* It was not until after the District Court had rendered its opinion accepting the finding of Hayden Stone and holding petitioners liable that petitioners for the first time on their motion for a new trial contended that the District Court should have accepted the lower *market price* of the Defiance shares as conclusive evidence of value.

In denying that motion, the District Court held (A 49):

> "Throughout the trial defendants accepted as authoritative the Hayden Stone report, including its valuation of the stock to be issued by Defiance at $14.49 per share and although they were given ample opportunity to challenge it or to offer any evidence tending to show a lower value for the Defiance stock, they chose not to do so. The report therefore constitutes probative and convincing evidence, particularly since it represents the results of an independent appraisal by recognized experts in the evaluation of corporate properties, who were eminently well qualified. Repeatedly the defendants pointed to the fairness of the report, Muscat going so far as to testify that the effect of the report was to render the Defiance transaction an arm's-length one."

The District Court could have arrived at a value other than $14.49 for the shares of Defiance only by disregarding petitioners' (and respondents') consistent position through-

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* Upon the trial petitioners contended only that Hayden Stone's evaluation of IIE at $70.51 per share was also correct. This was disputed by respondent and was the central issue at the trial.

out the trial, a position which petitioners abandoned only after the trial was concluded and judgment had been rendered against them. To belatedly give the pre-trial order the effect now contended for by petitioners would be to change *ex post facto* "the whole course of the trial, the whole tenor of it". *(Laird v. Carrier Engine Service Co.,* 263 F. 2d 948, 952 (5th Cir. 1959).)

The language of Mr. Justice Brennan, in an opinion in Chambers, in the case of *Appalachian Power Co.* v. *American Institute of Certified Public Accountants,* 361 U.S. 30, 4 L Ed 2d 30, 32 (1959), aptly applies to the case at bar:

> "But ordinarily an application by a District Court of the Rules of Civil Procedure when affirmed by the Court of Appeals will not be reviewed by this Court. This is particularly true where, as here, the question is one that concerns the judgment of the District Judge in relation to a particular set of facts."

We submit that the question here raised by the petitioners has no application to the facts of the case, and the decision of the District Court "made in relation to the particular set of facts" before it should not be reviewed by this Court.

Petitioners further contend (Pet. p. 25) that the allegation of the complaint that the Defiance's stock had a fair and reasonable value of $11.50 per share "should be binding on the plaintiff".* FRCP, Rule 8(f) expressly declares that "all pleadings shall be so construed as to do substantia justice". Rule 15(b) further provides that the allegations of a complaint do not preclude a court from rendering judgment in accordance with the facts as found by it after trial. This should be especially so in a derivative suit where

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* See: *Giannone* v. *United States Steel Corporation,* 238 F.2d 544, 547-548 (3rd Cir., 1956).

the rights of many absentee stockholders are involved. The District Court was fully justified in fixing the value of the Defiance stock at $14.49 per share, particularly since both sides accepted that valuation throughout the trial.

The Third and Fourth Questions

Petitioners contend (Pet. p. 27) that "no Court of Appeals has ruled on the requirement for *scienter* in an action for damages where §§ 10 and 14 overlap * * * " and petitioners urge (Pet. p. 29) that this Court should grant re- were not disclosed in the proxy statement, on the basis of which the Defiance-IIE exchange of stock was approved.

The issue raised by petitioners is irrelevant in the case at bar. The District Court found as a *fact* that petitioners had *personal knowledge* of at least two material facts which were not disclosed in the proxy, on the basis of which the Defiance-IIE exchange of stock was approved.

The principal issue on the trial was the fraud of petitioners in inflating the earnings of IIE's principal subsidiary, Nablico, and thereby inflating the value ascribed to IIE. The proxy statement represented the earnings of Nablico to be $2,098,013 for the period 1958-1961, inclusive. However, an audited report by the eminent accounting firm of Peat, Marwick, Mitchell & Co. certified Nablico's earnings for the same years to be only $1,501,882.* The District Court found *as a fact* (A 34) "that Huffines and Muscat, two knowledgeable and experienced business executives in charge of Nablico's affairs were aware of its true earnings".

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* In evaluating IIE, Hayden Stone had multiplied the inflated earnings of Nablico by 14 and 15 times and used the average of such multiplied earnings, plus a 25% premium for control, as the basis for its evaluation of Nablico. The impact of this method of evaluation upon the value of Nablico and, therefore, upon the value of IIE, needs no elaboration.

Again, it is undisputed that prior to the circulation of the proxy statement, two of Nablico's policy holders had instituted suit against it, claiming they were entitled to dividends equal to those paid to shareholders. Long before the proxy statement was mailed to Defiance's shareholders, those plaintiffs recovered judgment against Nablico in the sum of $5,500 on a motion for summary judgment (A 28).

Petitioners knew of this judgment before the proxy statement was issued (A 35). Moreover, they were fully aware that this judgment, in favor of two, out of many, policy holders, was a portent of more claims to come. As the District Court found (A 35), petitioners "knew of the adverse judgment and of the probability of substantial additional claims, facts which should have been disclosed in the proxy statement".* We submit that since the courts below found *on the facts* that petitioners had personal knowledge of the falsity of the proxy statement, the issue of *scienter* as a condition precedent to recovery under §§ 10 and 14 of the Act and Rules 10b-5 and 14a-9 is not an issue in this case.

Similarly, petitioners' contention (Pet. p. 30) that the "clearance" of the proxy statement by the staff of the SEC "negates fraud and shows due diligence", does not relate to the circumstances of this case. Petitioners seek to create the impression that the finding of fraud against them was based merely on an "alleged misclassification of the figures" (Pet. p. 31) and an improper arrangement "of the disclosed figures" (Pet. p. 32).

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* Up to March 1965 the amount paid in settlement of these claims was $162,000 (A 28) and, as the District Court held, the amount of "additional claims remains undetermined". (A 28)

However, the finding below that the proxy statement was false and misleading was not based, as petitioners would have it, merely on the *arrangement* in the proxy statement of *disclosed facts*. As noted above, *supra*, pp. 23-24, the finding of fraud in the proxy statement was based, in large part, on *undisclosed facts*. As the District Court held, these facts were known to the petitioners, but withheld from the SEC (A 37).*

Petitioners agree (Pet. p. 31) that "There may be cases of material omissions or misstatements, where scant comfort can be found in the clearance by the SEC". This case is surely one of them. In the instant case, the District Court expressly found (A 37) that "There is no indication that the SEC was aware, as were the defendants, of the inflation in the Nablico earnings figures used in the proxy solicitation material * * *." This is, therefor, a clear case of *knowingly* withholding material information from the SEC.

Again, it is clear from the record that the petitioners failed to disclose to the SEC the judgment which had been rendered against Nablico in favor of two of many similarly situated policy holders (A 28). It is obvious that that information, too, was withheld from the SEC, since it is inconceivable that, had it been disclosed, the SEC would

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* It may be noted that in *Mills* v. *Electric Auto-Lite Co.*, 403 F. 2d 429, 433 (2 Cir. 1968), judgment vacated, *supra*, U.S. , 24 L Ed 2d 593 the Court's finding that the proxy statement was misleading was based on the failure to give "the same emphasis" to the recommendation of the board of directors supporting the merger, as to the relationship of Electric Auto-Lite's directors with the principal corporate defendant. The Court in *Mills* noted that the disclosure of their "close relationship" came "many pages later". Thus, the falsity of the proxy statement in *Mills* was a matter only of the *arrangement* of the facts.

not have insisted upon the inclusion of this important fact in the proxy material. Accordingly, the District Court concluded that the SEC had been "misled" (A 37) by petitioners. Petitioners would hardly contend that the "clearance" of a proxy statement, where vital information has been *withheld* from the SEC, negates fraud.

The issues raised in questions 3 and 4, therefore, of the necessity of *scienter* as a condition to liability for a false proxy and as to whether a fully informed SEC "clearance" should insulate from such liability, is not present in this case. It would be a futile exercise for this Court to grant certiorari to discuss a *principle* applicable to a case, unlike the case at bar, in which all of the material facts *were* fairly disclosed.

The Fifth Question

What the petitioners really seek is a new hearing in this Court on the factual issues in this case. This Court, in "repeated pronouncements", has held that it 'cannot undertake to review concurrent findings of fact by two courts below, in the absence of a very obvious and exceptional showing of error'. E.g., *Graver Mfg. Co.* v. *Linde,* 336 U.S. 271, 275, 93 L Ed 672, 676, 677, 69 S. Ct. 535". (*Berenyi* v. *Immigration Service, supra,* (385 U.S. at p. 635); *Graver Mfg. Co.* v. *Linde,* 336 U.S. 271, 275, 93 L Ed 672, 676, 677, 69 S. Ct. 535 (1948); *Comstock* v. *Group of Institutional Investors,* 335 U.S. 211, 213-214, 230, 92 L Ed 1911, 1915, 1924 (1947).)

Petitioners contend (Pet. p. 32) that "without arguing the fairness of the exchange", if this Court "grants the instant petition on any of the previous points, to do substantial justice, it should review the finding that the ex-

change was grossly unfair". We submit that since the "previous points" raised by petitioners do not warrant review by this Court, the factual question of the fairness of the Defiance-IIE exchange certainly does not.

The fairness of the exchange ratio was the principal issue of fact litigated upon the trial. Upon the trial, both sides accepted the Hayden Stone evaluation of Defiance at $14.49 per share as proper. Petitioners' sole contention was that Hayden Stone's evaluation of IIE at $70.51 per share was also correct and that, therefore, the exchange ratio adopted was reasonable.

The District Court found, however, that with respect to IIE, Hayden Stone had been "misled" (A 45) because the purported earnings of Nablico (IIE's principal asset), supplied to Hayden Stone, had been substantially inflated (A 25). Accordingly, the District Court rejected Hayden Stone's evaluation of IIE and held that petitioners had caused Defiance "to pay $70.51 per share for IIE shares worth $40.58, or an excess of $29.93 per share" (A 34).

In these circumstances, the District Court necessarily concluded that the exchange involved "gross unfairness" (A 18) to Defiance. It is difficult to understand on what basis petitioners believe that this Court should review this issue of fact as decided by the District Court and affirmed by the Court of Appeals.*

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* We are at a loss to understand petitioners' statement (Pet. p. 32) that the SEC found that the income figures for Nablico stated in the proxy statement "were not false and misleading". As noted above, *supra* p. 26, the District Court found that the SEC was *unaware* of the gross inflation of Nablico's income figures.

CONCLUSION

The petition for a writ of certiorari should be denied since petitioners make no showing of any basis for such relief (Supreme Court Rule 19).

Respectfully submitted,

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APPENDIX

Federal Rules of Civil Procedure

Rule 8. General Rules of Pleading.

* * *

(f) *Construction of Pleadings.* All pleadings shall be so construed as to do substantial justice.

Rule 15. Amended and Supplemental Pleadings.

* * *

(b) Amendments to Conform to the Evidence. When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.

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SUPREME COURT RULES

Rule 19. Considerations governing review on certiorari.

1. A review on writ of certiorari is not a matter of right, but of sound judicial discretion, and will be granted only where there are special and important reasons therefor. The following, while neither controlling nor fully measuring the court's discretion, indicate the character of reasons which will be considered:

(a) Where a state court has decided a federal question of substance not theretofore determined by this court, or has decided it in a way probably not in accord with applicable decisions of this court.

(b) Where a court of appeals has rendered a decision in conflict with the decision of another court of appeals on the same matter; or has decided an important state or territorial question in a way in conflict with applicable state or territorial law; or has decided an important question of federal law which has not been, but should be, settled by this court; or has decided a federal question in a way in conflict with applicable decisions of this court; or has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this court's power of supervision.

2. The same general considerations outlined above will control in respect of petitions for writs of certiorari to review judgments of the Court of Claims, of the Court of Customs and Patent Appeals, or of any other court whose determinations are by law reviewable on writ of certiorari.